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A Month in the Markets

JULY 2023

In this latest edition our Multi Asset Solutions Team look at the challenges investment markets faced in June. Stock markets rose in June[1] as a slowdown in US inflation offered hope that the Federal Reserve (Fed) is nearing the end of its interest rate hiking cycle, improving the odds that the world's biggest economy will avoid a recession.[2]

Market Overview

Investor excitement over artificial intelligence (AI) prompted a rise in technology shares[3], driving the Nasdaq Composite index, a key index of US technology firms, to its fourth consecutive month of gains[4] and helping the Nikkei 225, Japan's benchmark stock index, reach a 33-year high.[5]

Shock interest rate hikes in Canada and Australia in the first week of the month reminded investors that the fight against inflation is far from over and resulted in bond yields rising as investors demanded greater returns on their investments.[6] As bond prices and yields move in opposite directions, this resulted in bond prices going downwards.

Yields rose again on June 22, when Fed Chair Jerome Powell suggested to US lawmakers that two more rate hikes might be in the pipeline, followed by the UK raising rates more than expected.[7]

At a gathering in Portugal toward the end of June, leading global central bankers pledged to stay on course with interest rate increases until the end, with stubborn inflation and strong job markets meaning that interest rates may remain higher for longer.

Despite the most intense series of interest rate increases in decades, central bankers from the Fed, European Central Bank (ECB), Bank of Japan (BoJ) and Bank of England (BoE) said their economies have proven stronger than expected and they don't anticipate a decline in growth.[8]

UK and Europe

Despite the optimism expressed by central banks, investor fears are rising that the UK might slip into a recession. Concerns have increased following the BoE's decision to raise interest rates by more than expected in June, in a bid to tackle inflation that has proved more stubborn than in many other major economies.[9]

This 13th consecutive rate hike[10] by the BoE came a day after data showed that inflation defied expectations and, instead of dropping, held steady in May. As a result, yields on two-year UK government bonds soared to their highest levels since 2008.[11]

Against this backdrop, June saw a UK business confidence index, which measures business leader optimism in prospects for the UK economy, experience its largest decline since the outbreak of the war in Ukraine. Investors are increasingly concerned that interest rates might rise from their current 5% to as high as 6.25% by the end of the year.[12]

Consumers are also feeling the impacts. Retail sales fell for a second successive month in June[13] and data released this month showed that households withdrew from their savings at a record pace during May, while borrowing slowed.[14]

Inflation also remains an ongoing concern in continental Europe, with the ECB hiking interest rates for the eighth consecutive time in mid-June.[15]

On 27 June, ECB President Christine Lagarde said it is unlikely that interest rates, already at a 22-year high[16], will peak in the near future. She indicated that officials would retain a bias in favour of higher rates even if they pause their hiking campaign in the coming months.[17]

Most ECB policymakers expect further interest rate hikes in July and September, despite signs that the Eurozone economy is declining in strength.[18] Business growth across the 20 nations that share the euro stalled in June as a decline in the manufacturing sector worsened, while the services sector barely grew.[19]

Core inflation, which excludes volatile items such as energy and food, rose during the month. Another worrying indicator was that two-year German bond yields, considered a benchmark for the region and the most sensitive to interest-rate expectations, also hit their highest levels since March.[20] However, headline inflation, which includes volatile items such as energy and food, fell to its lowest level since January 2022[21], sending mixed signals to policymakers.

US

Data released at the end of the month showed that the Fed's preferred measurement of inflation (core inflation) eased to its slowest pace in more than two years in May. At the same time, consumer spending was little changed, indicating that the US economy is starting to lose some momentum. This contrasts with other data pointing to the economy's resilience.[22]

In data released on 29 June, economic growth for the first quarter was amended to 2%, an impr0vement on a previous estimate of 1.3%. A separate report released on the same day showed that job layoffs were well below expectations, the US job market still appears strong despite 10 successive interest rate increases by the Fed.[23]

On 14 June, the Fed announced a pause in rate hikes, a year after inflation hit a 40-year high, although with the warning that it will continue to closely monitor economic conditions.[24] However, investors seem unconvinced and yields on two-year US government bonds rose during June[25], with traders pricing in an 84% chance of an interest rate increase at the Fed's July meeting.[26]

Nonetheless, expectations of only one more rate increase helped propel the S&P 500 Index, which tracks the largest companies listed on the New York Stock Exchange, to its highest level since April 2022.[27]

The Nasdaq Composite, comprised chiefly of tech companies, experienced its biggest monthly advance since March.[28] Surging interest in AI is driving the index to its best half-year since its inception in 1971, a dramatic contrast with its 30% collapse in the first six months of 2022.[29]

Asia Pacific

China's manufacturing sector declined in growth for a third consecutive month in June as activity in the construction and services sectors slowed, heaping pressure on authorities to inject more stimulus into the economy to fuel growth.[30]

The People's Bank of China – the Chinese central bank – reduced its primary benchmark lending rates for the first time in 10 months on 20 June, in a bid to encourage spending rather than saving and stimulate economic growth. This decision followed a number of economic warnings, with property investment declining in the first five months of the year while unemployment remained persistently high.[31]

Speculation has mounted that further rate cuts may follow or that some of the cash held by banks as reserves will be freed up to encourage lending.[32]

Near the end of June, Chinese state banks stepped in for the first time in nearly eight months in an attempt to halt a slide in the value of the yuan. Over the past two months, the currency has fallen around 4% compared to the dollar.[33]

Meanwhile, Japan's Nikkei 225 index, which measures the performance of 225 large companies across a wide range of sectors, rose for a sixth consecutive month in June. The index's sustained strong performance can, in part, be credited to soaring demand for technology companies, as well as an increase in investor interest in the Japanese market after Warren Buffet announced he was expanding his investments in it.[34]

The strong Japanese stock market performance has also been fuelled by better-than-expected company earnings, which have been aided by a weak yen that has made Japanese exports cheaper.[35]

Another factor making Japanese shares more attractive to investors is the trend of corporate buy-backs, in which a business buys and cancels a portion of its shares, thereby raising the per-share income a shareholder is entitled to. Share buy-backs have surged and could match last year's record of $66.1 billion, with improved returns potentially attracting more foreign investors.[36]

Despite inflation that has exceeded its target for 13 months, the BoJ maintained its ultra-low interest rate policy stance, with the goal of supporting the nation's economic recovery.[37] Data released in the first week of June showed that Japan's economy expanded 2.7% in the first quarter of the year, significantly higher than an earlier estimate of 1.6%.[38]

Outlook

We forecast low economic growth, but not a global recession. We also anticipate a gradual reduction in inflation.

We expect economic growth in the second half of the year to reflect the impact of the banking turmoil earlier in the year, as lending conditions tighten. Banks have significantly raised their lending standards, following the collapse of two US banks in March, making it more challenging to get a loan.[39]

Our view is that inflation is likely to remain outside central banks' targets for some time, so we believe interest rates will stay higher for longer.

Central banks appear to be nearing the peak of the interest rate hiking cycle, which should result in a market environment that is favourable to bonds for the next 12 months as inflation eases. However, we're not rushing to further increase our government bond position as we believe they will trade in relatively narrow price ranges over the short term.

As long as the global economy doesn't tip into a recession, company bonds offering higher yields than government bonds are particularly attractive.

We don't believe shares will continue their recent strong performance in an environment of weak economic growth.

Asset
Management

All data as at 30 June 2023.

[1] MSCI World IMI Index, 29 June 2023
[2] Reuters, 30 June 2023
[3] Business Insider, 30 June 2023
[4] CNBC, 30 June 2023
[5] Reuters, 13 June 2023
[6] Bloomberg, 8 June 2023
[7] Reuters, 22 June 2023
[8] Associated Press, 28 June 2023
[9] Associated Press, 22 June 2023
[10] Bank of England, 30 June 2023
[11] Reuters, 21 June 2023
[12] Bloomberg, 30 June 2023
[13] Reuters, 26 June 2023
[14] Reuters, 29 June 2023
[15] Reuters, 15 June 2023
[16] Investopedia, 15 June 2023
[17] Bloomberg, 27 June 2023
[18] Reuters, 27 June 2023
[19] Reuters, 23 June 2023
[20] Reuters, 30 June 2023
[21] CNBC, 30 June 2023
[22] Bloomberg, 30 June 2023
[23] CNBC, 29 June 2023
[24] The Guardian, 14 June 2023
[25] CNBC, 30 June 2023
[26] CNBC, 30 June 2023
[27] Associated Press, 30 June 2023
[28] Dow Jones, 30 June 2023
[29] Forbes, 28 June 2023
[30] Reuters, 30 June 2023
[31] CNN, 20 June 2023
[32] Bloomberg, 26 June 2023
[33] Reuters, 27 June 2023
[34] Reuters, 30 June 2023
[35] CNBC, 26 June 2023
[36] The Mainichi, 10 June 2023
[37] Reuters, 16 June 2023
[38] CNBC, 7 June 2023
[39] Fox Business, 17 June 2023